Pension Reform:

Opportunities and Challenges for USAID

USAID Financial Sector Review and Strategy Forum

December 11th, 2002

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Today's Discussion

1. **The Importance of Pension Reform**
2. Recent Trends and Key Issues
3. Opportunities and Challenges for USAID
4. Potential Approaches – Example from India
5. Suggested Next Steps

Objectives of a National Pension System

Avoid <u>future social costs</u> associated with a large number of elderly poor

- ***Income***: Ensure adequate retirement income to system participants
- ***Coverage***: Achieve full coverage of an appropriate target group
- ***Sustainability***: Maintain long-term financial sustainability of the system
- ***Growth***: Support (or at least do not hinder) general economic growth

Risk Management!

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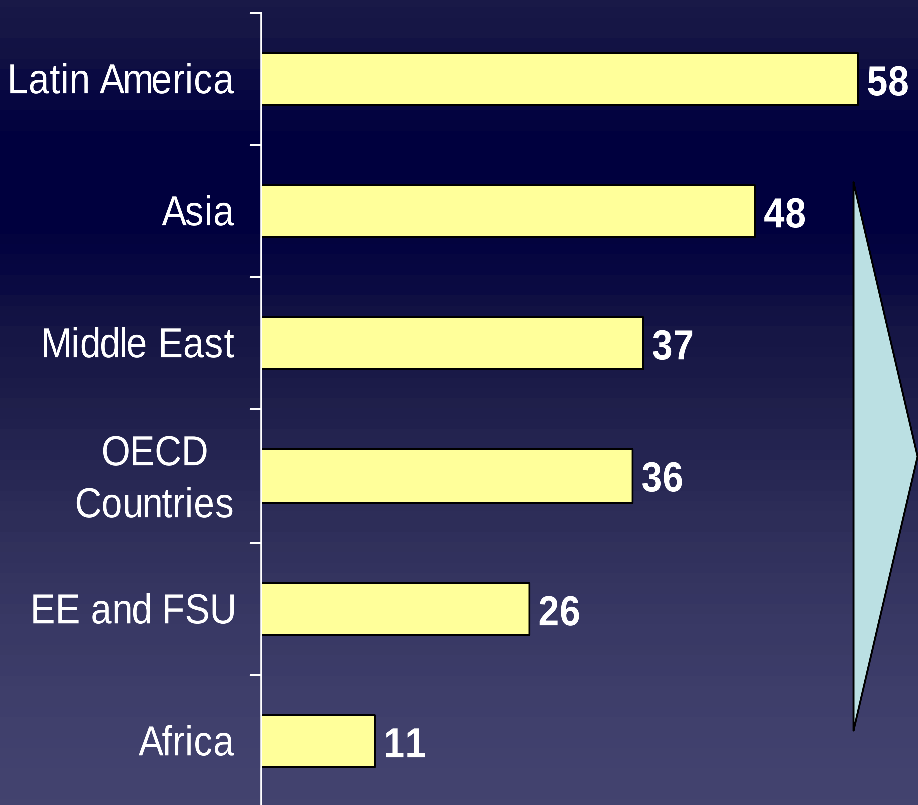
Demographic Drivers of Pension Reform

Percentage Increase in Percent of Population Over 60, 2000-2020

By Region….



…And for Selected Countries

Cambodia	**80%**
Thailand	**73%**
Brazil	**70%**
China	**57%**
Indonesia	**49%**
Azerbaijan	**46%**

Source: World Bank staff estimates

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High Social Costs of Pension “Mistakes”

Poorly Designed, Regulated or Managed Pension Programs Can…

- **Crowd out private savings and investment:** In India, \$9.5 billion in mandatory contributions (10% of participants’ salaries, 2% of GDP) are invested only in government instruments and state-owned companies.
- **Strain government budgets:** In Uganda, annual liabilities for civil service pensions alone are larger than the annual budget for health care.
- **Cause civil unrest:** Trade unions in Korea collected 2 million signatures and threatened to boycott social security contributions over a mismanaged expansion of mandatory coverage to the self-employed.
- **Redistribute wealth from the poor to the rich:** In the US, the collapse of Enron bankrupted many workers’ retirement plans; in Thailand, general tax revenues are used to contribute to civil servants’ pension plans.

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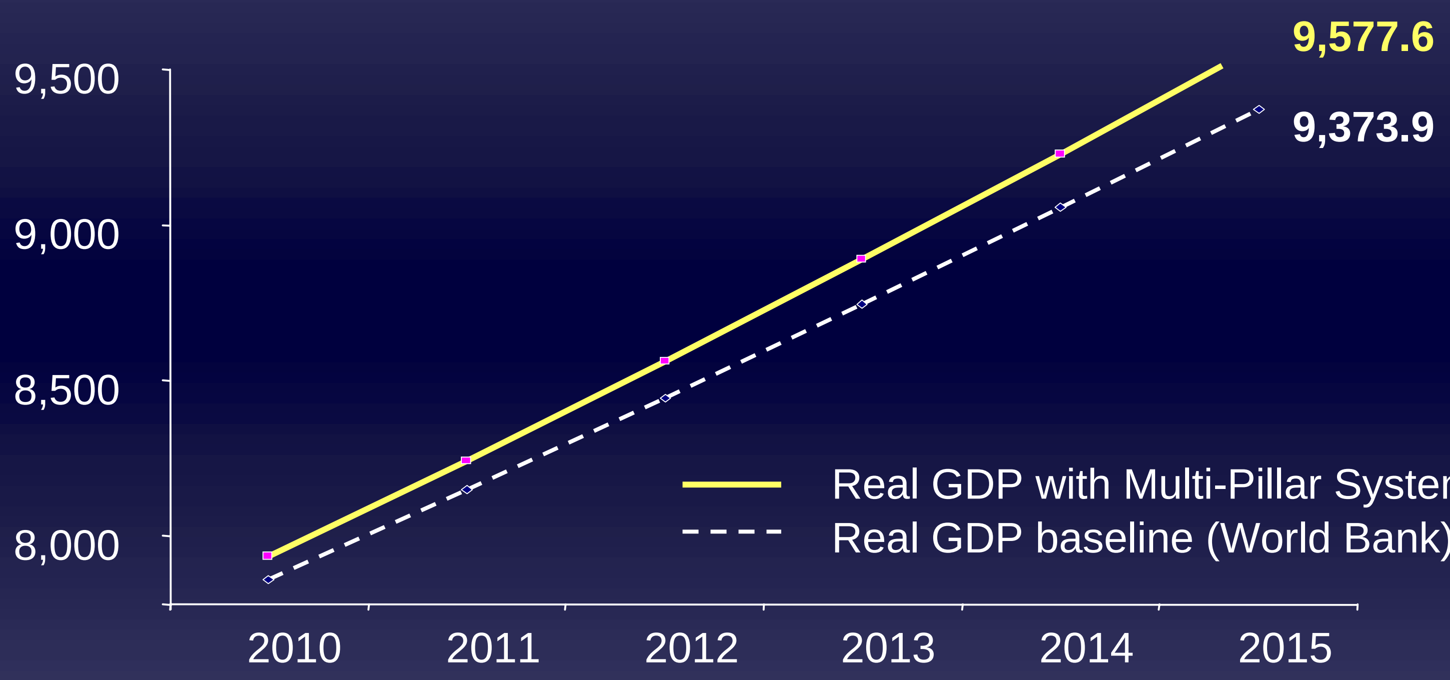
Potential Benefits of "Getting it Right"

Sample Projections from Thailand: Estimated Potential GDP Growth



Also, Chile claims its reformed pension system has resulted in: 1) higher productivity of capital, 2) more efficient capital markets, 3) new financial instruments, and 4) improved standards of corporate governance…

Source: Deloitte Touche Tohmatsu econometric analysis

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Types of Pension Programs

National pension systems can have one or more of these elements…

Pillar I	• Government-sponsored, mandatory social security pension program • Often contributory, defined benefit, financed on a pay-as-you-go basis • At times a flat-rate pension, income tested, based on residency, and/or paid from general revenue
Pillar II	• Mandatory, defined contribution, individual account pension program, usually invested by private pension fund management companies • Usually allows choice of investments by individuals or employers • Contributions can be taxed at time these are made or at time of claim
Pillar III	• Any voluntary retirement savings plans, sponsored either by employers or by individuals • In some countries, voluntary contributions are made by individuals to the same pension fund management companies as the Pillar

Risk Management!

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Relative Advantages of Each Pillar

In a multi-pillar model, disadvantages are offset by other Pillars' advantages.

PILLAR	TYPICAL ADVANTAGES	TYPICAL DISADVANTAGES
Pillar I	• Income redistribution • Quick pension generation • Index pensions to inflation • Relatively simple to administer • Less need for complex administration	• Inadequate benefits • Weak contribution/benefit link • Vulnerable to demographic shocks • Vulnerable to political pressures • Subject to wage manipulation
Pillar II	• Strong benefit/contribution link • Insulated from demographic shocks • Can increase savings / investment • Can strengthen capital markets	• No redistribution or poverty alleviation • Long time required to pay full pensions • Unpredictable pensions not indexed • Complex to administer and regulate
Pillar III	• Adaptable to diverse employer needs • Simple and inexpensive to administer • Limited government involvement • Reinforces individual accountability	• No redistribution or poverty alleviation • Difficult to index pensions to inflation • Difficult to expand to smaller employers • Limited labor mobility

Current Issues in Pension Reform

The general trend is away from Pillar I towards multi-pillar systems…

- **Defined contribution instead of defined benefit**
- **More private management of assets (instead of government control)**
- **Greater individual choice in contribution and investment decisions**
- **More funding of mandatory pension plans**
- **New ways to blend pillars and provide minimum guarantees**
- **Coverage for the poor, self-employed and informal sector workers**
- **“Second generation” technical assistance – compliance and enforcement, anti-money laundering, governance, etc.**

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Potential Opportunities for USAID…

What does USAID have to offer in pension reform?

- **Many USAID client countries are in need of assistance**
- **Fits with strategic objectives: strengthen financial markets, foster private sector growth, alleviate poverty, build institutional capacity, etc.**
- **Can link into and support activities in related intervention areas**
- ***USAID advantages*:**
  - ✓ **able to provide substantial amounts of grant assistance**
  - ✓ **access to a wide range of external and internal expertise**
  - ✓ **can provide the "whole package" of assistance**
  - ✓ **can get engaged LT with dedicated in-country teams**

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…And Key Challenges

What challenges and pitfalls will USAID face?

- **To be effective and sustainable, pension reforms cannot lead -- should follow basic, multi-sector interventions**
- **Highly political, many vested interests**
- **No magic pill - each solution must be tailored**
- **Impacts hit many other sectors: to capital markets, anti-money laundering, corporate governance**
- **Impact on poverty alleviation is not obvious: requires careful consideration and appropriate interventions, as well as proactive “public relations” to ensure continued political support**

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Project Background

Pension Reform in India: Initial Needs Assessment

In August 2001, Deloitte was contracted by USAID/India to undertake a comprehensive assessment of the pension sector in India. This assessment focused on five areas:

1. **Legal, policy and regulatory framework for private pensions**
2. **Pension system for civil servants**
3. **Advocacy, education and consumer protection**
4. **Training and research**
5. **International donor initiatives related to pension reform**

Objective:

To help USAID/India understand the pension sector, and determine which, if any, interventions should be included in the new country strategy.

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Our Approach to the Project

A Structured, Objectives-Driven Methodology

Step 1:

Evaluate existing pension programs against objectives: income, coverage, sustainability, and growth.

Step 2:

Identify gaps, from which develop a "long-list" of potential areas for intervention

Step 3:

Evaluate intervention options using established screening criteria

Step 4:

Recommend interventions, w/associated implementation action plan

1. ***What interventions are needed to help meet the objectives?***
2. ***Which of these can USAID most successfully implement?***

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Selecting the Best Potential Interventions

Screening Criteria and Prioritization Matrix

- **Does the intervention address a real need? Does it fit with USAID's objectives?**
- **Does USAID have comparative advantage v. other donors? Will the Gov't 'buy in'?**
- ***Is it likely to achieve impact that outweighs its cost and difficulty?***

Ease of Implementation	Low	High
Easy	**"Quick Hits"** • Implement selectively • Use as momentum builders	**"Urgent Actions"** • Implement immediately • Publicize results
Hard	**"Low Priority Actions"** • Ignore or implement opportunistically	**"High Priority Actions"** • Begin planning now • Implement in phases

Expected Impact

Ease of Implementation:

- Cost
- Complexity
- Risk
- Time required

Expected Impact:

- Income
- Coverage
- Sustainability
- Economic Growth

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Outcome and Lessons Learned

Ensuring the Best “Bang for the Buck”

- **We provided USAID with a prioritized, detailed “menu” of five potential interventions, with initial Action Plans for each.**
- **Intervention packages spanned a broad range of areas, objectives and skill requirements as well as cost levels.**
- **“Quick hits” were combined with “Urgent Actions” and longer-term initiatives to combine rapid results with lasting impact.**

Clearly identify problems and probability of success before developing solutions, thereby ensuring interventions are appropriate and resources are not wasted.

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Applying the Lessons Learned

Potential Next Steps for USAID

- **Replicate the India project design and approach in other countries where pension reform might be a concern – OEG can create a template and share experiences across Missions**
  - **The initial assessment is low cost and can be completed quickly**
  - **Undertaking the assessment provides some “insurance” that subsequent interventions will be sequenced appropriately, targeted, efficient and, ultimately, more successful.**
- **Consider using similar assessment methodologies for other sectors, e.g. SME and microfinance, capital markets, or banking reform.**

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Applying the Lessons Learned (cont'd)

"Generic" Approach to Designing Interventions in Pension Reform

Stage 1: Framework	**Stage 2: Implementation and Beyond**
• Design appropriate LT strategy for new systems: policy objectives? multi-pillar? coverage targets? level of income protection? • Identify reforms for existing systems: parametric changes to existing systems or new system needed? managing transition costs?	• Regulation/ supervision • Operational reforms for existing systems, plan administration • Financial management and IAS • Public education and advocacy • Corporate governance • IT and MIS systems

***Capacity Building*: Skills Development and Training**

***Consensus Building*: Public Relations**

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